COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR APPROVAL OF AN ALTERNATIVE METHOD OF REGULATION OF ITS RATES AND SERVICE	))))	CASE NO. 98-426

O R D E R

On January 28, 2000, Metro Human Needs Alliance, Inc. ("MHNA"), People Organized and Working for Energy Reform ("POWER") and the Kentucky Industrial Utility Customers, Inc. ("KIUC") filed petitions for rehearing on certain issues arising from the Commission's January 7, 2000 Order requiring Louisville Gas and Electric Company ("LG&E") to reduce its electric rates. LG&E filed a petition for rehearing on January 31, 2000, and the Kentucky Association for Community Action, Inc. ("KACA") filed a petition for rehearing on February 1, 2000.[1]

Based on the petitions, the responses, and the replies thereto, the Commission makes the following findings.

Depreciation Expense

LG&E requests that the Commission reconsider its rejection of LG&E's proposed increase of $1,420,000 to test-period depreciation expense. LG&E contends that, contrary to the finding in the January 7, 2000 Order, it did provide adequate support for its proposed adjustment and that it answered the assertions made by KIUC. LG&E

[1] While KACA's petition was filed after the deadline established by KRS 278.400, the issues raised by KACA are essentially the same as those raised by MHNA and POWER, which are addressed in this Order.

included with its petition for rehearing copies of supporting schedules showing detailed plant and functional account balances, corresponding depreciation rates, and the calculation of the depreciation accruals. LG&E notes that both the Commission and KIUC agreed with the concept of the proposed depreciation adjustment.

In its February 7, 2000 response, KIUC opposes rehearing this issue. KIUC claims that KRS 278.400 prohibits LG&E from providing additional evidence on rehearing which could have been provided at the original hearing. KIUC further argues that even if LG&E's post-hearing evidence is proper, the requested depreciation adjustment still has not been supported, as KIUC's original concerns about misclassified construction work in progress balances still remain. KIUC cites confusing terminology included on the submitted schedules and the apparent inclusion of fully amortized plant in the depreciation expense calculations as further problems with LG&E's depreciation schedules.

The Commission rejected LG&E's proposed depreciation adjustment, finding that the supporting schedule submitted by LG&E "fails to provide the various plant balances and corresponding depreciation rates, items needed in order to verify the reasonableness of the calculations."[2] Until it filed its petition for rehearing, LG&E had not provided this level of detail in support of the proposed adjustment, even though such

[2] January 7, 2000 Order at 88.

detail had been previously requested.[3] Of additional concern is the fact that all the detailed schedules first provided by LG&E with its petition for rehearing are dated "5/6/99", which LG&E acknowledged was the date the schedules were printed.[4] Thus, this information was readily available to LG&E for almost four months prior to the hearing but was not provided. As clearly demonstrated by Attachment A to LG&E's February 14, 2000 Reply, months before the hearing Kentucky Utilities Company filed in its rate case the detailed depreciation schedules by plant account that LG&E also had but chose not to offer until rehearing.

LG&E argues in its petition that the Commission has historically given utilities the opportunity to present additional evidence on rehearing in support of a proposed adjustment. However, the standard contained in KRS 278.400 for additional evidence is that the evidence could not with reasonable diligence have been offered during the initial hearing. Since the supporting schedules filed with the petition for rehearing are dated May 6, 1999, any claim that this information could have not been offered during the initial hearing lacks merit. This is especially true, considering that LG&E's responses to data requests seeking this information were filed after the May 6, 1999 date.

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[3] "Please identify, describe, and quantify all proforma adjustments to per books Kentucky retail jurisdictional ratemaking components that the Company believes are appropriate for the test year ending December 31, 1998." See Response to KIUC's 3rd Data Request dated April 30, 1999, Item 39, response filed May 10, 1999. "Provide detailed workpapers that support each of LG&E's proposed adjustments. These workpapers shall include all calculations, assumptions, and other documentation used in determining the proposed adjustments." See Response to the Commission's July 16, 1999 Order, Item 1(c), response filed July 26, 1999.

[4] LG&E Reply to KIUC's Response to Petition for Rehearing, filed February 14, 2000 at 3.

The Commission found in the January 7, 2000 Order that LG&E had the burden of proof to support its proposed depreciation expense adjustment, and that LG&E failed to adequately support that adjustment. The Commission now finds that LG&E is not entitled to a rehearing to submit evidence that was prepared and in its possession months before the initial hearing but not timely filed. Therefore, the Commission denies rehearing on this adjustment.

Clarification of ESM Calculations

LG&E requested that the optional earnings sharing mechanism ("ESM") set forth in the January 7, 2000 Order be clarified to provide that any required calculations will reflect Commission decisions that have a current or future impact on revenues or expenses. LG&E cited three examples of decisions that should be reflected in the ESM. One is the March 1, 2000 electric rate reduction that LG&E states needs to be annualized to avoid overstating revenues for January and February 2000. Another is the sharing of merger savings with shareholders, which LG&E states needs to be reflected in the ESM by an adjustment to operating expenses. The last is the need to adjust the ESM to reflect over- or under-earnings to avoid double counting those earnings when determining the ESM.

In response, KIUC stated that it agreed in principle that the financial impact of Commission decisions should be reflected in the ESM calculations. However, KIUC expressed no opinion on the three specific examples cited by LG&E.

Based on a review of the arguments presented, the Commission finds good cause to grant rehearing on this issue to further investigate which decisions need to be reflected in the ESM calculation and how they should be reflected in that calculation.

Revenue Allocations

LG&E requests that the January 7, 2000 Order be modified to allow it to present future proposals, either in conjunction with an annual review of its ESM or as part of a rate unbundling study, as to differences in class rates of return that would permit adjustments to class revenue allocations but be neutral as to total jurisdictional revenues. KIUC argues that what LG&E proposes is unclear and that a ruling now on the role that class costs of service might play in a future rate unbundling proceeding would be premature.

The Commission finds that LG&E has not clearly stated its proposal and, thus, the request to now modify the January 7, 2000 Order is premature. However, since this issue was precipitated by our decisions to offer LG&E an ESM and to require a report on rate unbundling, we find it appropriate to grant rehearing for the purpose of clarifying the proposal and determining what, if any, ruling is necessary at this time. Therefore, for these purposes, rehearing will be granted on the issue of revenue allocation in future proceedings resulting from the January 7, 2000 Order.

Unbundling Report

The January 7, 2000 Order in this case requires LG&E to file a detailed report by May 1, 2000 discussing the issue of rate unbundling for informational purposes and a suggested methodology to accurately determine the generation, transmission, and distribution components of its rates. LG&E states that it is willing to file the report, but requests that it be permitted to make that filing no later than January 1, 2001, so that it may prepare the report in conjunction with the rate unbundling plan that must be filed by its affiliate in Virginia. LG&E notes that this extension will allow it to prepare and file its unbundling studies in a comprehensive, efficient, and cost-effective manner.

KIUC states that it has no objection to delaying the filing of the unbundling plan. Robert Madison opposes the extension, and states that he supports the May 1, 2000 deadline required by the January 7, 2000 Order.

The Commission finds that LG&E's request is reasonable and should be granted. We agree with LG&E that it would be more efficient to time the filing of the report on unbundling for informational purposes with the unbundling filing to be made in Virginia.

Off-System Sales and Purchased Power

KIUC requests rehearing on the adjustments made for off-system sales revenues and purchased power expense. KIUC argues that the adjustments, which go out 8 months beyond the end of the test period, violate the matching principle, produce an arbitrary result for LG&E, and, by relying on post-hearing information responses, violate its due process rights. KIUC also claims the adjustments, if let stand, should also reflect the results of LG&E's brokered sales.

We find some merit in KIUC's arguments on these issues, as discussed below. The rate-making standard to which the Commission is held is the reasonableness of the results achieved, not strict adherence to a specific method or formula. Recognizing events or circumstances within a test year that make it unrepresentative of ongoing conditions, or recognizing changes occurring during the test year that will impact ongoing operations when the new rates will be in effect are two of several situations that justify a degree of flexibility in the rate-making process. Given the changes that occurred in 1998 in the wholesale power markets resulting from the tight capacity and related price spikes, it was entirely appropriate to recognize those changes. These were the two items for which adjustments were proposed to recognize these changes. If other adjustments had been proposed for the other items of revenue and expense KIUC includes in its argument, we would have been required to consider those as well. While we did not accept LG&E's adjustment based on projections for calendar year 2000, we did find it reasonable and appropriate to recognize, to some extent, the impact of the dramatic changes in 1998 in the wholesale power markets. That recognition was afforded in the adjustments approved in the January 7, 2000 Order.

KIUC claims that the adjustment to increase LG&E's purchased power expense is arbitrary because it results in a greater increase than that proposed by LG&E. The Commission finds KIUC's argument to be baseless. The Commission's adjustments are not limited by the amounts proposed by the utility anymore than they are limited by the amounts proposed by the intervenors. The Commission expressly rejected LG&E's adjustment because it was based on a forecast, adopting instead an adjustment based on a current historical period. To reduce the resulting adjustment merely because it was greater than the amount proposed by LG&E would set a standard for arbitrariness that would indeed be difficult to exceed. A utility has a legal right to recover all reasonable, necessary expenses and the Commission has a duty to determine the appropriate level of the expenses so that rates will be fair, just and reasonable.

LG&E's proposed adjustments to its test year off-system sales and purchased power expense were at issue throughout this proceeding and KIUC was well aware of that as evidenced by its consistent opposition thereto. KIUC cannot reasonably claim that the Commission was limited to either accepting LG&E's proposed adjustment based on year 2000 projections or making no adjustment, which was KIUC's recommendation. The Commission has both the latitude and the expertise to fashion rate-making adjustments of its own if the record supports a determination that such adjustments are reasonable and appropriate. However, since some of the data underlying these two adjustments had not been subject to investigation in this proceeding, or in a formal review of LG&E's fuel adjustment clause, we will grant rehearing for the limited purpose of conducting an investigation of LG&E's off-system sales and purchased power expense for the 12 months ending August 1999. Since the details of the underlying data are within LG&E's records, the rehearing phase will be expedited by requiring LG&E to address this issue in its testimony to be filed on March 2, 2000.

KIUC previously raised the issue of brokered sales in its post-hearing brief and it was considered and addressed in our January 7, 2000 Order. It has been further addressed and described in detail in LG&E's response to KIUC's request for rehearing. Nothing contained in KIUC's rehearing petition raises any new issue or presents any new evidence that was not already considered. Therefore, we find no basis to grant rehearing or to modify our original adjustment to reflect LG&E's brokered sales.

<u>Environmental Surcharge Revenues</u>

In its application for rehearing, KIUC alleges that LG&E's rate reduction should be increased by $1.081 million due to an error in the calculation of the level of environmental surcharge revenues. KIUC states that the effects of the 1999 Environmental Surcharge Settlement Agreement ("Settlement Agreement") in Case No.

94-332[5] were properly recognized by the Commission in adjusting environmental capitalization and operating expenses, but not properly recognized in adjusting revenues. KIUC argues that this error results in a mismatch between the environmental revenues, operating expenses, and capitalization.

KIUC had previously raised this same alleged error in its response to LG&E's motion for correction and LG&E previously filed a reply to KIUC's response. In that reply, LG&E addressed KIUC's alleged error by characterizing KIUC's position as arbitrary and unreasonable. LG&E claims that KIUC's argument is based on the false premise that the amount of environmental compliance cost removed from the environmental surcharge pursuant to the Settlement Agreement cannot be recovered through base rates. LG&E contends that nothing in the Kentucky Supreme Court Opinion, the Settlement Agreement, or the Commission's August 17, 1999 Order approving the Settlement Agreement prohibits LG&E from recovering through base rates its current costs of environmental projects built prior to or under construction on January 1, 1993, a right that has been acknowledged by KIUC. LG&E states that the Commission correctly intended to exclude all per book revenues and expenses

[5] Case No. 94-332, The Application of Louisville Gas and Electric Company for Approval of a Compliance Plan and to Assess a Surcharge Pursuant to KRS 278.183 to Recover Costs of Compliance with Environmental Requirements for Coal Combustion Wastes and By-Products. On August 17, 1999, the Commission approved a unanimous Settlement Agreement which resolved all outstanding issues and pending litigation relating to LG&E's environmental surcharge. The Settlement Agreement was in response to the December 17, 1998 Opinion of the Supreme Court of Kentucky in Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Co., Ky., 983 S.W.2d 493 (1998). As a result of the Settlement Agreement, certain expenses and investments were no longer recovered through the surcharge mechanism.

associated with environmental surcharge recovery in the test period, including the Settlement Agreement expenses and rate base items.

As the Commission stated in its February 9, 2000 Order in this case, this was the first base rate case that included an environmental surcharge, and many of the issues decided were ones of first impression. Consequently, rehearing should be granted to afford all parties a further opportunity to investigate and evaluate whether the environmental surcharge revenues removed from the determination of LG&E's base rates properly reflected the effects of the Settlement Agreement.

Low-Income Funding Proposal

KACA, MHNA and POWER (collectively "the Low-Income Group" or "LIG") request reconsideration of the Commission's decision to deny their proposal to require LG&E to impose a line charge for all customer billings in order to create a universal energy assistance fund for low-income customers. Contrary to the findings in our January 7, 2000 Order, LIG argues that the Commission has the statutory authority to establish a low-income assistance program and to require LG&E ratepayers to provide the funds for such a program.

LG&E replied to the LIG petitions, arguing that the Commission's January 7, 2000 decision on this issue was correct. LG&E acknowledges that federal assistance programs for low-income customers are being reduced, but states that the creation and continuation of such programs is a matter to be dealt with by legislation, not regulation. LG&E further states that the Commission is not authorized to compel utility companies and their customers to participate in such programs absent specific legislative authority or utility consent.

The Commission finds that LIG has not presented any argument in support of their proposals that was not previously presented and considered by the Commission. Absent specific state or federal legislation, the Commission is prohibited under KRS 278.030 and 278.170 from imposing the type of program and funding mechanism LIG has proposed. While funding for low-income programs has been included, on occasion, in settlement agreements that have been approved by the Commission, in only one instance did the program permit participants to pay less than the utility's authorized rates or require ratepayers to fund the program.[6] That program, agreed to as a pilot by the utility and all customer representatives, requires shareholders to bear 50 percent of the program's costs. Even so, at the time of its approval, the Commission expressed reservations that the program did not fully comport with KRS Chapter 278.[7] As noted in the January 7, 2000 Order, in its initial phase that pilot program has failed to produce the type of benefits that LIG's members attribute to such programs.

LIG has offered no persuasive evidence in support of the argument that the Commission has the authority to mandate their proposed program absent consent of all participants. As the Commission has previously stated, this is a legislative issue that will need to be resolved by the Kentucky General Assembly. We note that the members of LIG are currently supporting such legislation, Senate Bill 211, which would authorize the Commission to mandate energy assistance programs for low-income customers. Finding no basis to grant rehearing, we deny the LIG requests on this issue.

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[6] Case No. 94-179, An Adjustment of Rates of Columbia Gas of Kentucky, Inc. On and After July 1, 1994, Order dated November 1, 1994 at 6.

[7] Id., at 5.

Service Quality

MHNA and POWER argue that, with the approval of an ESM, the Commission should establish additional measures to monitor LG&E's service quality. They claim that under an ESM, cost-cutting measures may be implemented to increase profits at the expense of service quality. They claim there was no evidence properly introduced in this proceeding to establish LG&E's current quality of service and, therefore, there is no basis for the Commission to award LG&E a superior service rating. MHNA and POWER state that LG&E should be required to file SAIDI and SAIFI calculations on a regular basis and also include a measure of its response time to severe storms.

LG&E respond by stating that MHNA and POWER cite nothing to rebut the Commission's conclusion that existing reporting requirements are sufficient to ensure that it maintains its existing level of service. LG&E also cites MHNA and POWER's post-hearing brief wherein they cited the different statutes governing rates and service and concluded that, "the company can be neither penalized or rewarded through a rate adjustment." LG&E states that no additional monitoring is necessary or required.

A review of the evidence, the petition of MHNA and POWER, and LG&E's response thereto leads the Commission to conclude that no additional monitoring of LG&E's service quality is required in conjunction with the implementation of an ESM. The Commission has the authority to require the filing by LG&E of whatever information it deems necessary to gauge service quality. That information can include SAIDI and SAIFI calculations, as well as a measure of response time to severe storms. However, MHNA and POWER have produced no persuasive arguments that such information, and the related reporting requirements, must necessarily be imposed in conjunction with the implementation of an ESM. The Commission will continue to monitor existing service reporting requirements and will not hesitate to take remedial steps should any degradation of service be noted. Therefore, MHNA and POWER's request is denied.

Other Issues

Based on a review of the myriad of pleadings filed since issuing the January 7, 2000 Order, the Commission notes three issues that were not included in a timely request for rehearing but do warrant some discussion. Two were raised by KIUC, one by Robert Madison.

In its response to LG&E's motion for corrections, KIUC claims that the illustrative tariffs attached to that motion as Appendix B are flawed in that the Bill Reduction component of the performance-based rate-making ("PBR") tariff implemented on July 2, 1999 is not continued until the March 1, 2000 effective date of the base rate reduction. KIUC also claims that, as a result of the provisions of these tariffs, ratepayers lose some portion of the merger dispatch savings that would have continued to flow through the fuel adjustment clause ("FAC") had it not been suspended when the PBR tariffs were implemented. KIUC argues that the ratepayers' loss will be permanent unless remedial action is taken by the Commission.

LG&E replied to KIUC, citing the tariff language that states that the Bill Reduction component of the PBR tariff remains in effect through February of 2000, consistent with the Commission's Order dated January 7, 2000. LG&E also replied that ratepayers will not lose any portion of merger dispatch savings under its proposed tariffs. Its PBR adjustment factors for the first quarter of 2000, which were filed with the Commission on December 20, 1999, show the inclusion of the merger dispatch savings for the third calendar quarter of 1999, which was the first quarter the PBR tariffs were in effect. Furthermore, the PBR tariffs filed in this case on January 20, 2000, state that they are closed effective January 7, 2000, and are thereafter limited to the disposition of the last two billing calendar quarters of 1999. Accordingly, the merger dispatch savings for the last two calendar quarters of 1999 will be received by customers through the PBR tariffs during the first two calendar quarters of 2000. With the reinstatement of the FAC effective March 1, 2000, the merger dispatch savings for January will begin to be reflected in customers bills through the fuel clause factors based on January's fuel costs as reflected in the fuel clause factors billed to customers in March 2000.

Based on a review of the illustrative tariffs, LG&E intends to continue the Bill Reduction portion of the PBR tariff through February 2000 and the Merger Dispatch Savings will also continue uninterrupted with no savings loss to ratepayers. Absent any loss to ratepayers, no Commission action is needed on these issues.

Mr. Madison claims that LG&E increased its gas rates approximately 18 percent as of December 28, 1999 and alleges that such increase was due to the elimination of the subsidy of LG&E's gas operations by its electric operations. Since the electric rate reductions imposed by the January 7, 2000 Order will be effective for bills rendered on and after March 1, 2000, Mr. Madison suggest that LG&E's gas rate increase should have also been delayed until March 1, 2000. Based on a review of LG&E's gas rates, the Commission finds that no increase was authorized to offset the future reduction in electric rates. While there are insufficient facts of record to determine with certainty the gas rate increase referenced by Mr. Madison, LG&E was authorized to increase its gas rates on and after November 1, 1999 to recover higher gas costs of 71.17 cents per

Mcf, an increase of 24 percent over its previous gas rates. This gas rate increase, however, was months before, and totally independent of, the electric rate reduction.

IT IS THEREFORE ORDERED that:

1. Rehearing is granted to investigate which Commission decisions need to be reflected in the ESM calculation and how those decisions should be reflected in that calculation.

2. Rehearing is granted for the purpose of clarifying LG&E's proposal concerning the issue of revenue allocation in future proceedings resulting from the January 7, 2000 Order.

3. Rehearing is granted on delaying the filing date of LG&E's unbundling report, which shall be filed with the Commission no later than January 1, 2001.

4. Rehearing is granted to investigate LG&E's level of off-system sales and purchased power expense for the 12-month period ending August 31, 1999. LG&E shall address this issue in its testimony to be filed on March 2, 2000.

5. Rehearing is granted to investigate and evaluate whether the environmental surcharge revenues removed from the determination of LG&E's base rates properly reflected the effects of the Settlement Agreement.

6. Ordering paragraphs Nos. 2 and 3 of the Commission's February 9, 2000 Order shall apply to the issues granted rehearing herein as if separately so ordered.

7. Rehearing on all other issues is denied.

Done at Frankfort, Kentucky, this 17th day of February, 2000.

By the Commission

ATTEST:

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Executive Director